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SUBJECT: VOLOGDA OBLAST: KEEPING AFLOAT - SO FAR

1. (SBU) Summary. While Vologda Oblast's dependence on the ferrous metallurgy industry -- particularly steel exports -- renders it vulnerable to the global economic downturn, regional authorities thus far have managed to mitigate much of the impact thanks to Moscow's financial assistance and the oblast's own rainy day fund. Through increased unemployment benefits, retraining for displaced workers, and encouraging employers to cut hours rather than staff, Vologda oblast and city authorities have managed to largely insulate this key oblast from the economic downturn, at least, as they acknowledge, for the present. The goal, as one local official blurted out, is to prevent social unrest. End Summary.

The Perils of a Mono-Sector Economy

2. (SBU) Consul General and a Consulate team visited the Vologda oblast February 25-27 to assess the repercussions of the global economic crisis. Vologda Oblast is located in the northern part of European Russia and its administrative center, Vologda, is 400 miles east-southeast of St. Petersburg. The oblast has a population of around 1.5 million people and, being second in per capita industrial output in Russia, is relatively prosperous. Ferrous metallurgy directly and indirectly accounts for about 80 percent of the region's GDP, despite relatively successful efforts by regional authorities to diversify the oblast's economic base by developing enterprises in the, timber, and food processing, and glass and plastic bottle industries.

3. (SBU) The sharp reduction in international demand for steel and steel products has hit the oblast particularly hard. Governor Vyacheslav Pozgalov stated that 4,000 people (out of a total of 30,000 employees at the end of 2008) have already lost their jobs at the steel giant Severstal. However, he also said that this number was reduced from an initial estimate of 13,500 due to Severstal's coordination efforts with the government. Governor Pozgalov pointed out that his government's overall development strategy, which aims to diversify further the oblast's economy, has remained unchanged, and could even benefit in a narrow sense from the global economic crisis. Pozgalov said that during the past few years around \$2.5bln had been invested into the development of local infrastructure and that the oblast as such was well positioned for rapid development. In the short run, however, Pozgalov said that maintaining social stability in the oblast during the crisis was a top priority. As such, his administration's key objectives are to minimize staff cuts at local enterprises, create new jobs for workers displaced by the economic downturn, support development of small and medium enterprises, and ensure the social safety net is able to support all those whose lives are disrupted by the economic situation.

Maintaining Employment and Avoiding Social Unrest

4. (SBU) As part of its efforts to maintain social stability, the oblast administration has banded together with trade unions and the management of major enterprises in an effort to replace staff cuts with various other cost savings measures, such as salary cuts, shortened work weeks, and encouragement of unpaid leaves of absence (with the guarantee to employees of being able

to return to their jobs when desired). The government has also established a special agency which re-trains unemployed workers and/or employs them in various public work projects.

15. (SBU) A key program is supporting the development of small and medium enterprises. According to Governor Pozgalov, the oblast administration is subsidizing interest rates on commercial loans and providing grants of up to RUR300,000 (\$8,300) to small businesses. The federal government also has kicked in RUR1bln (\$27.6mln) for SME development. Among other steps to encourage business development is a ten-percent reduction in tax rates for local small businesses. Nikolay Tikhomirov, Speaker of the Vologda Oblast Legislative Assembly said that, in addition to the tax break, unemployed people who start their own businesses would be entitled to receive a year's worth of unemployment benefits as a lump sum to invest into their new businesses. According to Tikhomirov, during the past couple of months, as many as 800 people have decided to start their own businesses in Vologda Oblast. Overall, the authorities hope that these measures will help create 3,500 new jobs. Other measures also include providing free land and below-market rate lumber to anyone wishing to build a home literally from scratch. Participants in this program can sell the homes, if they wish, or sell the lumber itself and use the proceeds to start a business.

Keeping the Home Blast Furnaces Burning

16. (SBU) Nikolay Kutovskiy, the Acting Mayor of Cherepovets (a city more populous and economically important than the capital Vologda itself and home to Severstal's huge steel plant), was a little less optimistic regarding the prospect that small businesses could help alleviate the unemployment uptick expected in the oblast. He explained that many small businesses in his city provided services to the metallurgical plant, and so the sharp reduction of output at Severstal itself was thus affecting those smaller businesses as well. According to Kutovskiy, unemployment figures in Cherepovets grew from zero to two percent over the past three months, and he expected it to rise further in the near future. He said that consequently the city government planned to create around 9,000 new jobs in public works and believed that the measures being taken by the regional and the city governments would help avoid any serious social unrest. He underscored that the most important thing was to ensure social order and keep people out of the streets.

17. (SBU) According to Andrey Lutsenko, the Technical Director of Severstal's plant in Cherepovets, Severstal company has experienced a very sharp drop in demand since November 2008. As a result, it has shut down three of its five blast furnaces (representing about 45% of its capacity) as well as its open-hearth furnace. He added that, although there was some growth in demand in the first quarter of 2009 compared to the fourth quarter of 2008, he does not expect any considerable recovery in production in the near future, as all the main consumers of ferrous metallurgical products remain in a deep crisis both in Russia and abroad. Lutsenko said that, given this situation, some cost cutting has been and will be inevitable. However, he underscored that Severstal supported the regional government's efforts to protect the labor market and thus the cost-cutting emphasis has been on reducing outlays on capital equipment investment and attempting to increase production efficiency. (Note: Severstal's main blast furnace, which is still operating, underwent a major overhaul in 2006, and as such already is very efficient.) To minimize staffing cuts, Severstal has introduced a reduced working week and begun encouraging early retirement for its employees.

18. (SBU) As was the case in other areas of Russia, the Vologda Oblast had, until the crisis began, faced a severe shortage of qualified workers. Yevgeniy Shulepov, the Mayor of Vologda, said that even today the number of unemployed in the city is equal to the current number of job vacancies. Marina Romanova, head of foreign economic relations for the small municipality of Kirillov (a small provincial town not far from Vologda city), said that the increase in unemployment benefits has revealed

previously hidden unemployment. People who heretofore had not bothered to sign up for unemployment because the paid benefit was so low have recently come out of the woodwork. Now, her local administration also is able to fill low-paying city jobs that previously went begging for applicants.

19. (SBU) Comment. Vologda Oblast is akin to a company oblast, not simply a company town. Most senior officials, from the oblast governor to the city mayors and their teams, came from Severstal. Efforts to diversify the oblast's economy have made an impact, but Severstal remains the keystone industry. Vologda's rainy-day fund will help the oblast and its major cities weather the economic crisis for a while, but as one deputy mayor underscored, regional and local authorities do not know how hard the steel industry will be hit or how long the downturn will last, so they're feeling very uncertain about the future.

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